RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 •

POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038
26 LETTERS PER YEAR • $225 ANNUALLY

Oct. 18, 1989 **LETTER 1028**

Oct. 6 DJIA 2785.52; PTI 3281; A-D Ratio -5.81
Oct. 13 DJIA 2569.26; PTI 3273; A-D Ratio -7.10
Dow Yield: 4.01%; Dow P/E: 11.0; Dow Pow: 610
Dow Book Value: 1075; Dow 200-day MA: 2458
Percentage of Undervalued Blue-chips: 14%

ENCORE?: On October 13 (Friday) the Dow plunged a shocking 190 points together with a 78 point drop in the Transports and an 11 point smash in the Utility Average. The supposed "trigger" for the crash was the unraveling (actually, the banks pulled out) of the financing for UAL, a major leveraged buy-out. That unpleasant news came out late in the day, and the market took it from there.

What do we really know at this time? For one thing, we know that the underwriters are finding it damn hard to sell junk bonds. And we also know that October is becoming a dirty word on Wall Street. The three major crashes of modern history, 1929, 1987, and now 1989, all took place during the month of October.

What don't we know? We don't know at this time whether this latest crash was just another unfortunate "mistake" as per October 1987 -- or whether October 13, 1989 spells finis for the great recovery of 1987-89. To really know what's happening it's going to take time. There's no way around it, it's going to take time.

Here's something we do know. The Dow Theory rendered a bear signal on October 13. Please follow this logic: in early September the Dow hit a record high of **2759.09** while the Transports also struck a record high of **1532.01**. From there the Averages suffered a one-month decline, hitting lows in late-September (see page 1 chart).

Next, on October 9 the Industrial Average rallied to a new record high of **2781.41**. On the same day the Transports advanced to **1518.49**, which was not a new high. Note that on the latest rally the Transports failed to confirm the new all-time high in the Dow. A few indecisive days went by. On October 13, the market crashed. The crash saw the two Averages plunge below their late-September lows on high volume.

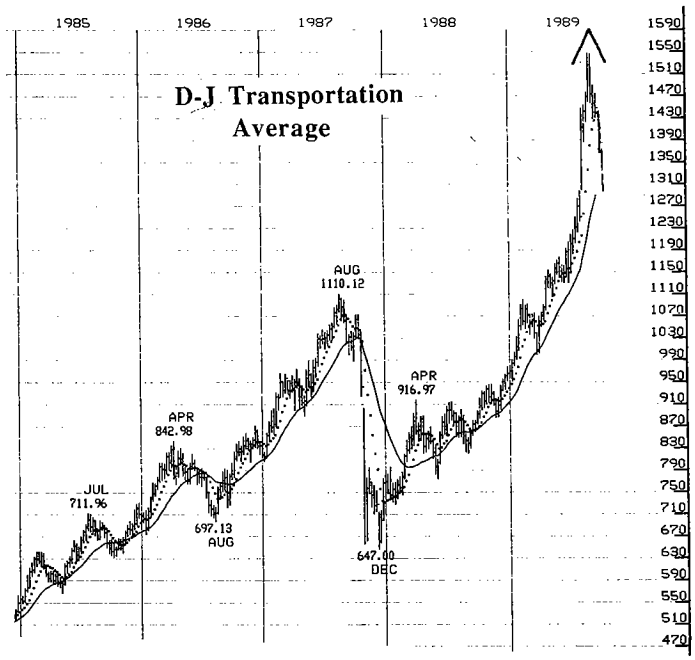
So to review, we had highs in both Averages, a one-month decline, a new rally taking the Dow to an unconfirmed high -- and then a smash which took both Averages below their preceding lows. This is the formula for a Dow Theory bear signal. From a Dow Theory standpoint, the primary trend is now down.

What's the general reaction to last week's crash? Judging from what I read in the newspapers and from commentators on TV the reaction has been, "This isn't all that serious. It's just another market 'freak-out,' a sort of mini-copy of 1987. The program boys have knocked the market on the head again, but by the end of the year the market will be at new highs."

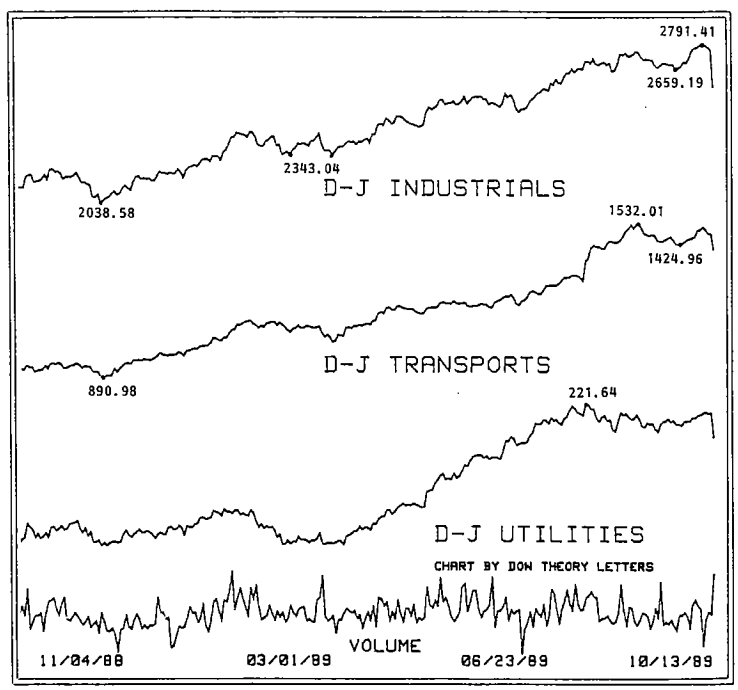
Maybe so, but the market seldom puts on the same show twice. And one thing I do note. The Dow hit its 1987 bull market high on August 5 at 2722.42. Two years have gone by, and as of this writing the Dow is well under that figure. That's hardly what you can call progress. Some might even call it ominous.

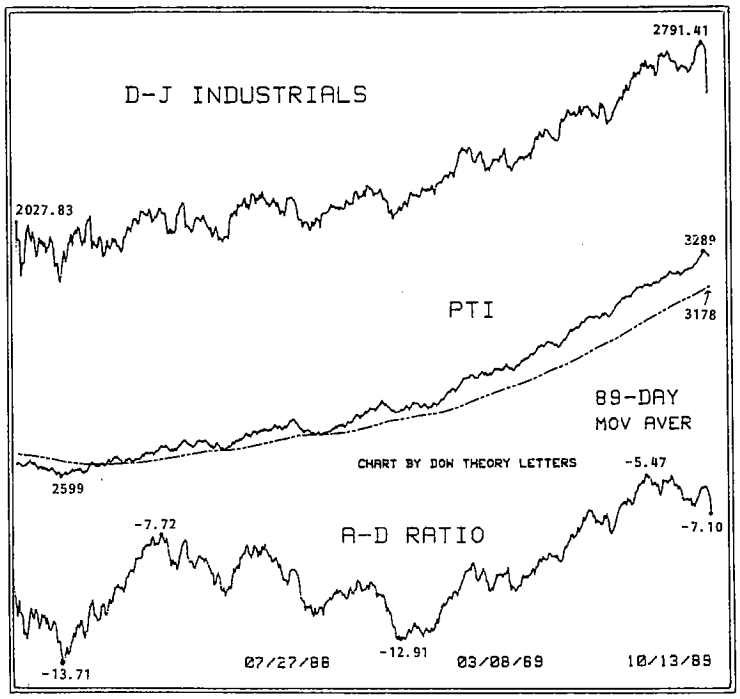
In another part of this Letter I include a section on values, and I also include a chart showing that at the recent highs the S&P 500 was selling at over 30 times dividends. History tells us that whenever the S&P sells at better than 30 times dividends, the stock market is treading on thin ice. I've mentioned this many times in recent Letters, and it's the reason I've had the bull (see "Investment Position") trembling in the box.

Then there's another problem which I outlined in the last Letter. The Transportation Average has been climbing in a pattern that I



term a parabolic curve. A parabolic curve (see chart) occurs when the price action follows a steadily increasing rate of ascent -- until finally the path is literally straight up. The parabola usually ends with a spear-point top -- and then a smash. That's exactly what





happened to the Averages in 1987. And that's what happened to the Transports here in 1989.

But again, was last week's crash just another fake-out on the part of the market? Are we fools to be largely out of stocks? Frankly, I don't think so. But as I've so often said, Russell's first investment rule is, "Above all, don't lose money." And when the averages sell at better than 30 times dividends, history tells us that stockholders are walking on thin ice.

INVESTMENT POSITION: I don't know how I could have made it any clearer. In recent Letters I stated my own market position, which was largely OUT of stocks and largely in cash or muni cash funds (I chose muni cash funds, since here in California they kill you with taxes, and the muni cash fund is a way around those taxes).

?

Now I know (because I read the ads too) that today we're all supposed to be beating the markets via stocks, junk bonds, commodities, baseball cards, masterpiece pictures, you name it. Nobody rests, everybody is busy making a killing. But believe me, there's really nothing wrong with being on the sidelines. Moreover, today's sidelines are a lot better than the sidelines of 1960 or '70. Today they pay you 5.4% (totally tax-free) to stand aside while you watch your neighbor making a fortune in soybean futures or S&P options. Besides, we old-timers remember when a taxable 5% was considered a gift from heaven (remember the "magic fives"?). So basically I've just been watching the show, and I've suggested that my subscribers do the same.

When the crash came last week I must admit I felt good about being on the sidelines. And what now? Now I'm going to be patient, and I'm going to give the market time. After all, we did get a Dow Theory bear signal. And stocks are hardly on the bargain counter. The chaos in the junk bond market is giving the big boys plenty to think about, and the institutions and funds are wondering whether to sit or sell.I'll just keep collecting my safe, tax-free 5.4%.

I'm going to be conservative here. Based on Dow Theory I could put a bear in the box. But I'm going to put a question mark there instead, and the question mark is going to stay there until I get a confirming bearish signal from my PTI (remember, it takes time before the PTI can trace out a bearish trend).

SUMMATION INDEX: Over the years I've attempted to develop various indices, indicators, and techniques -- all in an effort to help my subscribers (and me) operate successfully in the market. In that process I've used the classic Dow Theory as the foundation for my work.

The problem with the Dow Theory (and, of course, the problem with all technical analysis) lies in its interpretation. It's the old story, a story best described in the chartists credo: "The charts are always right, it's only the chartists who are wrong." The same problem confronts every Dow Theorist. The Theory is great, it's the Dow Theorists who make the wrong diagnoses.

One of the market problems I foresaw many years ago was the rise in popularity of technical analysis plus the problem of too many technicians using the same tools and following the same data. This is the reason I began during the late-1960s looking for some exclusive vehicle, some device of my own, which would help me to determine the trend of the market. I worked on this problem for five years, testing hundreds of items. Finally, I came up with one which satisfied me. I called it my Primary Trend Index (PTI).

In 1971 I began publishing the PTI in these reports. The PTI was an indicator based strictly on market action. Since 1971 I have used the PTI as a fail-safe way of always being on the right side of the stock market. Now comes the embarrassing part. In reviewing my dealings with the PTI over the past 18 years, I would say without hesitation that my biggest mistakes have come when I injected my own prejudices and preconceived notions while refusing to believe what the PTI was saying.

In all honesty I think I would have been better off (from an investment standpoint) if I had locked myself in a room with no access to the outside world and simply been given one statistic. That statistic would be the PTI figure for the day. In other words, just investing on the basis of the trend of the PTI would have proved extremely profitable. Subscribers who have been with me for a decade or longer (and who have used the PTI exclusively in their investing) can testify to that.

But a few things about the PTI must be understood. The PTI does not deal with overbought or oversold markets. It deals strictly with market direction. Most investors would say that if you know market direction, that's enough. However, there is another critical area which we have to deal with. And that is the turns -- or technically, we have to deal with whether the stock market is heavily overbought or oversold.

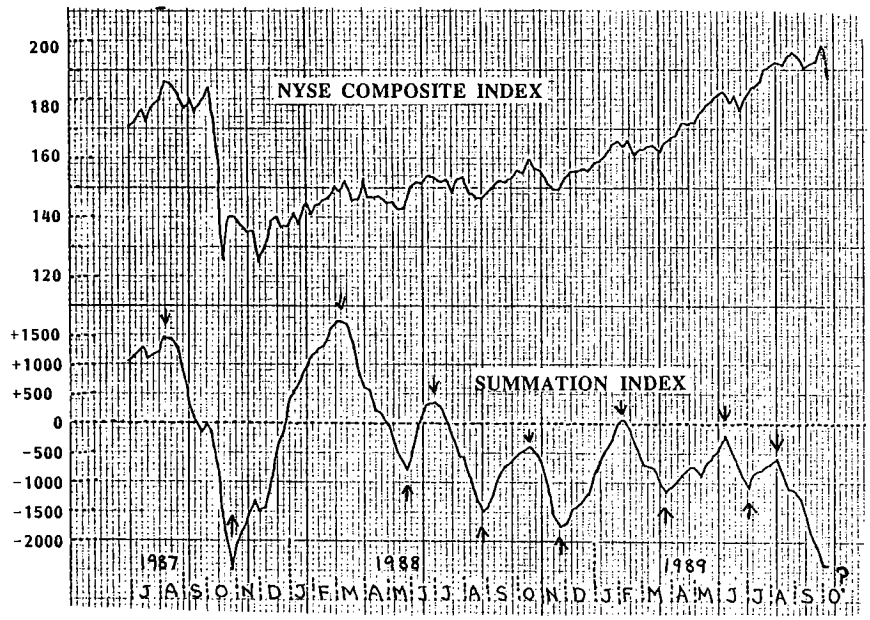
How do we do that? Happily, there is an excellent indicator which deals with overbought and oversold market conditions, and I have been following it for years. This is the so-called McClellan Oscillator and its companion tool, the Summation Index. Both of these instruments were developed by the great market technician, Sherman McClellan.

The McClellan Oscillator is based on the daily spread between two exponential moving averages of the advance-decline ratio -- a 19-week and a 39-week moving average. The explanation of the McClellan's action is a bit complicated so I won't go into it except to say that each day's figure (plus or minus) for the McClellan is added to the preceding day's total, and these totals are what we call the Summation Index (SI).

The SI normally swings between a high of around plus 800 to a low of around minus 1500. On rare occasions it will go extremes (for instance, at the 1987 crash low the SI dropped to an incredible minus 2640).

I use the Summation Index (SI) as follows: When the SI is rising, I take it that money is coming into the market, in which case the market is a buy. Conversely when the SI is falling, money is leaving the market, at which time the market is a sale.

I also find the SI valuable from another standpoint. I use it to gauge the strength of the market. For instance, when the SI is rising, I watch to see if the NYSE Composite moves up. If the Composite advances strongly with the rising SI, then I know that we're in a



strong market. On the other hand, if a rising SI fails to do much for the Composite -- watch out.

Conversely, when the SI is declining, I watch to see if that negative mode knocks the NYSE Composite down. If the Composite resists, I know that we have a potentially strong market despite the "sell phase" on the SI. But obviously, if a falling SI knocks the market down, I know we have a weak market. In a primary bull market, a falling SI tends to have a minimal effect on the stock averages. In a primary bear market, a rising SI will do little to raise the stock averages.

I include a **chart on page 3** showing the path of the Summation Index with the NYSE Composite going back to January 1987. You can see that during that period there have been seven declining SI phases, and in only one instance did a "sell-phase" produce any major damage to the stock market. That period, of course, was during the crash of 1987. Note, however, that you most definitely did receive a sell signal on the SI well before the crash.

But on July 26 1989 the SI turned down again (rememeber it's action is based on NYSE advances and declines), and since July 26 the SI has said, "bearish mode." On October 13 the bearish message of the SI finally rubbed off on the Dow, which crashed190 points on the day.

Current Status: The current situation is quite unusual. As you can see on the chart, the SI is now at its lowest level since the 1987 crash low. Frankly, I don't know how much lower the SI can go. But based on the duration and extent of the decline, I would guess (and it's only a guess) that the SI is near a bottom. If that's true, the next important direction of the SI will be UP. Normally, that should mean a period (four or five weeks) in which bullish pressure is brought to bear on the stock market.

So an interesting and very significant test lies ahead. (1) Judging from the level of the SI, the market is becoming very oversold (and the latest crash has simply intensified the oversold condition). (2) Consequently, the SI should soon bottom out and turn bullish. (3) When the SI does turn bullish, we will watch the response of the major averages. Since the 1987 crash low, all rises in the SI have sent the stock averages sharply higher. That "should" happen again. But if the averages don't respond bullishly to a rising SI -- watch out. That would be ominous action. A market that does not respond to a rising SI is all too often a bear market.

I have decided to run a chart of the Summation Index in each Letter from now on. I think that over time my subscribers will learn to use the SI to great advantage. In my own case, I find the SI to be invaluable.

VALUES: There are two ways of operating in the market. One is fundamental, and that is to invest on the basis of **values**. The other is **technical**, and that is to buy on the basis of whether the market is in a bull trend or a bear trend. Of course, there is a third way, and that's simply a combination of the above two.

The trend method is based mainly on technical analysis of the market. I attempt to cover this in each issue of these reports. I also publish statistics in each Letter which should help to appraise the market on the basis of value.

Perhaps the easiest and most accurate value analysis of stocks is based on the price-to-dividend multiple. This chart, **shown on page 4**, is courtesy of the excellent and highly recommended *Growth Fund Guide* (Box 6600, Rapid City, SD 57709). It is an historical chart in every sense of the word, since it takes the price/dividend multiple all the way back to 1900.

Note there are 13 down arrows on the chart, each pointing to a price/dividend ratio of 30 or over. So what we can conclude from this study is that any time the price/dividend ratio goes to 30 or more, the market is in an area of overvaluation. Another way of putting it is that at a multiple of 30 or more, the investor is simply paying too much for dividends.

But how much is too much? There have been seven instances since 1950 where the dividend/price ratio has risen substantially above 30 prior to the market topping out. I have blackened those areas on the chart, the last area being just before last week's crash.

Based on the current 11.42 in dividends, the S&P 500 was selling at 31.4 times dividends just before the recent crash. The price/dividend multiple was getting up there, no question about it. And that's the reason why prudent investors were cautious about the stock market. The 99-year history displayed on this chart counsels caution.

NOTES & QUOTES: The *Forbes* richest Americans list is out. This list contains 346 men and 54 women. Interesting -- a whopping 159 of them (39%) inherited their money. Of the 54 women, only one, Estee Lauder, made it herself. The rest married or inherited the money. Here's an item I found most interesting. Trammell Crow, the big real estate investor and builder, dropped from $775 million to $360 million. The drop in worth, it was stated, was due to "softness in commercial real estate." Is that telling us something?

* *

They keep bidding up the airline stocks, but quietly air traffic is beginning to slide. US Air reported last week that its traffic tumbled badly in the third quarter with its planes flying 56.3% full, down from only 57.4% in the same period last year. It added that its third and fourth quarter profits would be significantly lower than in '88. Russell question: What happens to these debt-logged carriers during even a mild recession?

* *

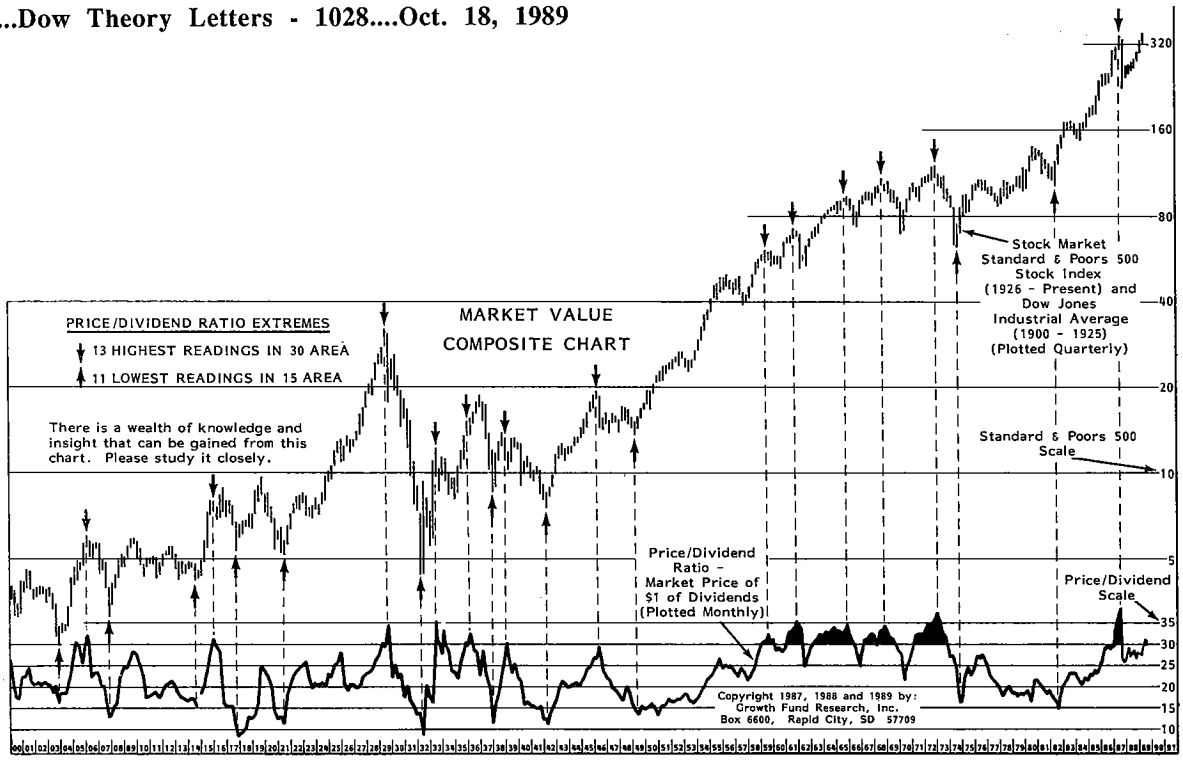
From the Oct. 10 *NY Times:* "The ten largest American securities firms all have offices in Tokyo that specialize in selling off American assets. . . . Contrary to the attitude of American investment bankers, who casually reshuffle assets, the Japanese view a company up for sale as an occasion for shame, and a stark admission of failure."

* *

Harry Figgie,Jr., chairman of Figgie International, believes that we have now produced the conditions which could lead to hyperinflation. They are: (1) A push to turn the Fed over to Congress, (2) large US deficits, (3) deterioration in our international balance-of-payments, (4) calls for protectionism, (5) eroding confidence in the nation's currency, (5) declining value of our currency in international markets.

* *

Singer Burl Ives bought a home in Montecito,Calif. in 1974 for $290,000. He just sold his home and moved to Washington state.


PRICE/DIVIDEND RATIO EXTREMES
13 HIGHEST READINGS IN 30 AREA
11 LOWEST READINGS IN 15 AREA
MARKET VALUE
COMPOSITE CHART
There is a wealth of knowledge and insight that can be gained from this chart. Please study it closely.
Stock Market Standard & Poors 500 Stock Index (1926 - Present) and Dow Jones Industrial Average (1900 - 1925) (Plotted Quarterly)
Standard & Poors 500 Scale
Price/Dividend Ratio - Market Price of $1 of Dividends (Plotted Monthly)
Price/Dividend Scale
Copyright 1987, 1988 and 1989 by: Growth Fund Research, Inc. Box 6600, Rapid City, SD 57709

Selling price for his $290,000 California home -- just under $4 million. And that's not an atypical case. The LA to Washington state move is becoming popular -- much to the consternation of Washingtonians.

* *

Henry Kravis and his partners started Kohlberg, Kravis Roberts 13 years ago with capital of $3 million. They now control interests in companies with a combined total of $70 billion in revenues. Who says you can't make it in America (with the help of a little leverage)?

* *

What are the cars that have captured the imagination of the car-loving American public? They are the 1908 Ford Model T, the 1953 Corvette, the 1957 VW Beetle, the 1964 Ford Mustang, the 1973 Honda Civic. And maybe, just maybe, the 1989 Mazda Miata.

* *

How are the luxury German car companies doing? They're sweating a bit. Mull this over -- so far, four out of 10 American Lexus (by Toyota) buyers have traded in German cars for their new luxury Japanese cars.

* *

Question: Why doesn't the US tell Japan, "Open your doors wide or we'll shut down the US to Japanese products?" Answer: We could have (and probably should have) done that 20 years go. Now it's too late. The US is too dependent on Japanese products. Chips, VCRs, TVs, many advanced technologies -- if we closed them off the US would shut down. Furthermore, we depend heavily on Japanese financing of US debts. Threaten Japan? Hardly, people and nations tread lightly where their creditors are concerned.

* *

California real estate prices are up in the wild blue yonder. According to the latest report from the National Association of Realtors, the median price of a home in San Diego is $176,000, San Francisco $265,000, LA $218,000 (the national average is $93,000). Furthermore, the housing affordability index for San Diego is 56.7, San Francisco 48.5 and LA 46.1. That means the average first-home buyer has around half the income required to finance a home in these areas.

* *

Despite the fact that the Bush administration is timid, obsessed with avoiding risk, and slow to react, George Bush is enjoying amazing popularity. Eight months into his presidency, 70% of Americans (by poll) approve of what he's doing. That's better than Presidents Reagan, Carter, Ford, or Nixon did at the same time in their presidencies. How come? Russell opinion: Bush is a good guy, no question about it. But nothing disastrous has happened that can be pinned on Bush. So far, the deficits, HUD mess, S&L fiasco, etc. can all be pinned on the Reagan presidency. Bush hasn't had a Bush disaster yet -- although his non-action regarding Panama comes mighty close.

* *

The cost of fighting drugs is skyrocketing. According to the October 3 *Financial World* ("Drugs, the Cases for Legalization"): 46% of all federal prisoners are doing time for drug-related crimes, it's costing taxpayers $30 billion a year for drug-related court costs, drug-abuse cases are costing hospitals $1 billion a year, and American business is down $60 billion from absenteeism and other abuses related to drugs. Furthermore, the government is spending over $8 billion a year in its antidrug war. In all, the drug costs have become astronomical.

* *

Quote of the Week: "We cannot afford our own passion to lock up people we find undesirable. This state and many other states will end up bankrupt from building all these prisons." From Larry Meachum, a Connecticut corrections commissioner. Note: For the first time in US history there are now more than 1 million prisoners in US jails and penitentiaries.

* *

Per capita income. In what nation does the average person make the most money? It used to be the US, but that was then and the following is now: Switzerland is No. 1 at $20,130 per person; No. 2 is Luxembourg at $19,9060; No. 3 Sweden at $17,160; No. 4 is (believe it or not) Iceland at $16,480; No. 5 is West Germany at $15,880; No. 6 is Norway at $15,250; No. 7 is France at $14,130; No. 8 is the USA at $14,080.

* *

Oh no, not Harley! Malcolm Glazer has just announced that he owns 6.2% of Harley-Davidson Motor Co. Harley, America's last and only motorcycle company (I own two Harleys), should not be a takeover. The company, after years of pain and strife, is finally doing beautifully and has (this is unbelievable) captured near 60% of the big bike market -- thereby routing the formerly dominant Japanese. No takeover could improve or help Harley. A Russell triple-curse on anyone who tries to take over Harley-Davidson Motor Co.

* *

Al Neuharth's book, "S.O.B.," is creating quite a stir. Neuharth, now retired as CEO of Gannett, was the man who created *USA Today*, the multi-color newspaper that changed the newspaper industry. Here's Neuharth's philosophy "In your teens, play all you can. In your 20s take all the risks you can. In your 30s learn

all you can. In your 40s earn all you can. In your 50s lead everywhere you can. In your 60s leave with all the style you can. Thereafter, or in the hereafter, enjoy all you can." Great philosophy or a justification for Neuharth's life? You be the judge.

* *

With a united Europe scheduled for 1992, the new capital of all-Europe will be Brussels. Already an army of 5,000 lobbyists and lawyers have moved into the city. Brussels is now booming with new construction and new businesses springing up in all directions. During the last two years the price of housing in Brussels has increased 50%.

Speaking of a united Europe, the plan is to have only one European currency. To my mind, the new European currency and the new united Europe could present a problem for the US. With Europe producing most of what it needs and with Europe increasingly feeling its own strength, I see the possibility of united Europe refusing to accept dollars unless the US cleans up its financial act. The fact is that the US is still running annual federal deficits of over $250 billion per year! No currency can withstand that kind of hemorrhaging for long -- and the European central bankers know it!

More Europe: Those wanting to have a piece of worldwide investing (minus the US) might consider two no-load mutual funds. They are: T. Rowe Price Int'l Stock with 20% in Japan, 19% in UK, and 10% in Germany (1-800-638 5660); and Scudder Int'l with 20% in Japan, 16% in UK, and 9% in Netherlands (1-800-225 2470).

* *

Free At Last: Photocopiers have been under lock and key and forbidden to Russians for 40 years. But last week the Soviet Ministry of the Interior announced that photocopiers will become standard office equipment. Russia is attempting to get its wrecked economy into the 20th century. But the big hurdle is still the almost worthless ruble. The quickest way to make the ruble acceptable would be to make it convertible into gold. I think that's going to happen, I really do!

* *

We read all about the Fed buying and selling dollars in order to "stabilize" the buck. But how does the Fed do, profit-wise, from its manipulations? The latest year in which info is available is 1988. In that year the US foreign exchange losses amounted to $511 million.

* *

You Gotta Push 'Em: Gabelli just brought out two funds. One, Gabelli Value Fund (with a sales fee of 5.5%), was pushed hard by 11,000 brokers at Shearson. They brought in $1 billion (I heard those guys and gals selling in the La Jolla office, and I mean they were on those phones!). The other fund, Gabelli Convertible Securities, was a no-load fund sold via post card (I bought a little). How much did the low-key post card campaign bring in for this no-load -- $16 million. So it pays to push -- at least it did for Gabelli.

* *

We live in a callous world today, but this has to be the ultimate in cynicism and callousness. The old trader calls out, "Hey kid, I hear you're flying to Seattle. Do me a favor. Here's 20 bucks. Take out an insurance policy naming me as the beneficiary." The kid replies, "Sure, OK, but how come?" Says the trader, "I woke up today feeling lucky." (I think I saw this one in a book ad or a book review somewhere.)

* *

Life expectancy for US blacks has fallen in two successive years. The declining rate for blacks is linked to two factors -- homicides and traffic accidents. Both of these can probably be connected to liquor and drugs.

LATE NOTES: Question: In the face of a Dow Theory bear signal, why didn't you put a bear in the box?

Answer: A Dow Theory bear signal entails the following: The two Averages, Industrials and Transports, trace out a full secondary reaction. They then embark on a rally in which one or both Averages fail to make new highs. Following the failing rally, the two Averages turn down and break their preceding secondary lows.

The question I ask myself (and it is an important one) is -- did the Averages trace out a full secondary correction from their September 1 highs? On the drop from the September 1 high the Dow declined 100 points while the Transports declined 108 points. These are big pointage drops, but they are not big percentage drops. Consequently, some Dow Theorists might feel that the drops were not large enough to qualify as secondary reactions.

But the decline from the highs did last for 25 trading days. From a duration standpoint it certainly qualifies as a secondary, so I'm voting to call the September declines true secondary reactions. But I'll admit that there is some question about my classification, and for that reason I want the bear classification to be confirmed by a definite, sustained declining trend in my PTI. That's going to take a little time. In the absence of a PTI confirmation, I'm putting a shaky question mark in the box.

Question: Following the 1987 crash you stated repeatedly that the **surest action in the market** is the almost guaranteed 50% (or more) retracement of the ground lost during the crash. Of course, following the 1987 crash the Averages retraced not only 50% -- they rallied to new record highs. Does the same "sure" action apply to the October 1989 crash?

Answer: Yes, it does. The Dow high recorded on October 9 just prior to the crash was 2791.41. From wherever the crash-decline in the Dow ends, you can almost bank on a retracement of 50% or more. The big question, of course, is at what level will the downside action end so the retracement can start?

Question: Technically, how does the crash of '89 differ from the crash of '87?

Answer: A Dow Theory bear signal was rendered on October 15, 1987, but the 508-point crash in the Dow came a few days later -- on October 19. On October 20, 1987 there were 1,273 new lows on the NYSE, a climactic figure that was never surpassed.

In the current case, the 190-Dow point crash itself (Oct. 13) provided the bear signal. But on October 13 there were only 93 new lows on the NYSE (that's right, only 93). The 93 lows hardly represent a climactic figure. This suggests that October 13 was not a climactic bottom day and that the market could go quite a bit lower before a real climax bottom is reached. Of course, if a primary bear market has begun, if my PTI is to embark on a major, extended decline, then the final low is going to be far into the future and the bear market has a long way to go on the downside.

Question: What fundamentals do you think were behind the crash?

Answer: I believe a great deal of the upside action since the 1987 crash was based on a revision of values for equities. Analysts and takeover (LBO) operators were revaluing stock after stock on the basis of their takeover value (i.e., their value if the stock was bought out and the assets sold off to cover the cost of some of the debt which was piled up during the takeover). After a while, the whole market started to be revalued based on an adding up of saleable assets.

But during 1989, the viability of many of the companies that had been taken over began to come into question. More recently, many of the takeover stocks began to run into trouble (Campeau, Harcourt Brace, Resorts, etc.), and the spread between average junk bond yields and Treasury bond yields rocketed to over 6% -- a danger signal.

The whole junk bond and LBO situation became dicier and dicier, with the airline stocks leading the junk parade. The banks were becoming queasy about the situation, and finally the big UAL takeover unraveled as the bank underwriters pulled out. This was

probably the trigger for last week's crash. But it was only the trigger. The underlying reasons for the crash had been building for a long time.

What the crash signified was probably the end of the takeover mania (and I called it "a mania" many times in these Letters). In the future, leveraged buyouts are going to be much more difficult to finance. And if a bear market has, in fact, started, the debt that is already in place in so many US corporations is going to be prove a millstone around the neck of the corporations and of the economy.

Question: How do you think the crash is going to affect the economy?

Answer: The immediate response to the crash, as I said earlier, is, "All is well, and this is just a mini version of October 1987." Maybe so, time will tell. But there's no question about it -- the stock market is very troubled about the amount of debt that corporate America has tied itself up with.

Alan Greenspan has come out favoring "zero inflation." With the advent of last week's crash, I don't think you'll be hearing much more about zero inflation from the Fed. Today's corporate structures couldn't hold together with zero inflation. Massive debt needs inflation to survive. Therefore, I think the Fed is going to allow 4-5% inflation to be the norm.

If a true, primary bear market has started, the current super-high level of corporate debt is going to play hell with America. In that case, I believe we'll see the Fed do everything in its power to fight the bear, and that includes new massive bailout loans and flooding the banks with free reserves. But again, if a true primary bear market has started, the Fed will be powerless to stop the forces of decline. There is just too much economic fragility in this nation. It exists in the housing price-structure, the commercial real estate price-structure, in the S&Ls, the banks, the insurance companies, and in the shaky structure of so many of America's over-leveraged corporations. It also exists with the consumers, who are loaded with "things" and up to their necks in debt.

So it all depends on one factor -- did the primary trend of the market and the economy turn down on October 13, 1989? We'll know the answer before the year is out. In the meantime, I believe there is a lot more to be lost betting that the trend is up than there is betting that the trend is down. In other words, the **risk/reward** at this time favors the bears, not the bulls.

One more thing: President Bush has enjoyed great personal popularity, despite the fact that he has been a passive, overly-careful, non-confrontational president. (Note Bush's jockeying around as he tries to get on the "popular" side of the abortion issue.) Bush has had almost no crises until now. My bet is that Bush's popularity has now **peaked**. He'll be seen from here on as a non-doer and as an ineffective president. That's the last thing the US needs at this time, and this unhappy fact will slowly dawn on the American public.

Question: What was your reaction to the market comments over the weekend and as trading opened this week?

Answer: I noticed that almost everyone treated the crash as an isolated incident based on program selling or the failure of the UAL financing. I didn't hear anyone talk about the crash as a Dow Theory bear signal, a signal for a major turn in the trend from bull to bear. Various analysts were asked where the decline would end, and they gave answers like Dow 2400, Dow 2200, etc. Of course, nobody has the slightest idea where the decline will end. IF it's a primary bear market, the decline will go farther than anyone is now talking about or thinking about. That, then, is the crux of it -- has the tide turned bearish or hasn't it.

GOLD: If you sit down and actually read the Constitution, the sections about money, you wonder how in heaven the US Congress, the President, the Supreme Court, and politicians in general ever got away with printing fiat (non-gold-backed) money. You wonder how they ever got away with putting the nation's monetary future in the hands of the Fed, and how or why the public ever let them do it. Of course, the answer is obvious. The public is ignorant of finance, the public is passive, and the public is trusting. Talk about misplaced trust!

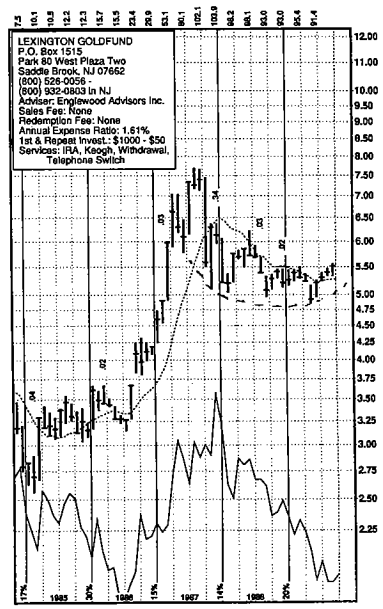
A recent letter to the *New York Times* puts the case quite succinctly. "In defiance of the Constitution (specifically Article 1, Section 8, concerning the power to coin money and regulate its value), Congress created in 1913 the Federal Reserve System, a corporate state banking cartel. Without Constitutional authority Congress declared Federal Reserve notes legal tender for all debt (1933). Congress then outlawed the redemption of those notes (or any government obligations) in gold coin (1933). Next, the government seized the American people's supply of gold (1933). It demonetized gold (1934). And at last Congress outlawed the redemption of Federal Reserve notes and paper currencies of the national government in silver (1968) -- thus substituting the fiat paper currency of a private banking consortium and the government's own base-metallic token coinage -- for the Constitutional regime of gold and silver."

It's really incredible, but somehow the politicians got away with it. A few weeks ago Faye and I had dinner with a law professor from the University of San Diego (he's a constitutional expert), and I asked this gentlemen how in hell the government could so blatantly circumvent items that were SPECIFICALLY spelled out in the nation's Constitution. He shrugged and said that "the Constitution is simply a matter of who's interpreting it and when."

Here are a few interesting notes: Did you know that the Constitution states that "No state shall . . . make any Thing but gold and silver Coin a Tender in Payment of Debts?" Did you know that the Constitution states that "No State shall . . . emit Bills of Credit" and furthermore that the Constitution delegates no power to "Congress to emit such "Bills" (bills of credit are paper money)? Did you know that the Fed (composed of thousands of private banks) ultimately controls the supply of money although the Constitution specifically states that only Congress has the power "to coin Money and regulate the Value thereof?" Ah, well, the history of inflation and paper money is a long and devious one. Yet fiat (paper) money is an item that the framers of the Constitution repeatedly warned against.

Gold, the metal, still acts sluggishly, although 360 does seem to stand as the base. And before you can get a bull move, you have to establish a strong base -- and you have to test and retest that base many times.

Do the gold shares know something that the metal doesn't? It would seem that way. At any rate, here's **Lexington Gold Fund** (chart courtesy of *Growth Fund Guide,* Box 6600, Rapid City, SD 57709). This no-load fund is a good proxy for gold shares in general, and as you can see the fund has hurdled its moving average and moved higher for four successive months. I have outlined (dashed line) a sort of saucer bottom for the fund, and this suggests that a strong base has formed.



NEXT MAILING:

Nov. 1